PRESS INFORMATION from

The Dairy Group

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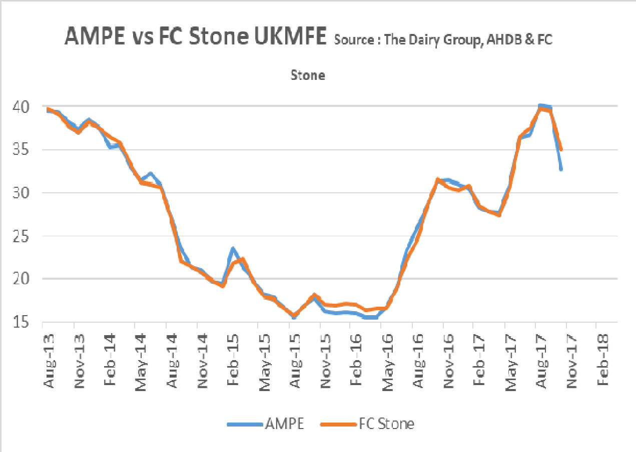
Futures Milk Pricing Flounders on Excessive Deductions, Rigid Commitment and Market Volatility

***By Nick Holt-Martyn,* The Dairy Group**

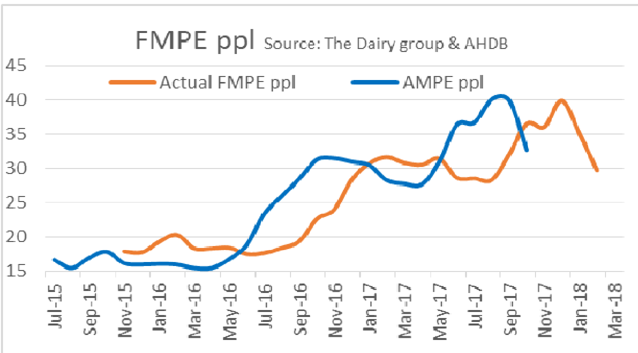
"With futures milk equivalents hitting almost 40 ppl in recent months it's not surprising that attempts have been made to enable farmers to access these markets to underpin their own conventional farm gate price" says Nick Holt-Martyn of The Dairy Group. He goes on to say "unfortunately these initiatives are in danger of collapse due to combination of excessive deductions from the AMPE equivalent price, rigid tie ins for up to 12 months and the market volatility of the EEX due to a lack of liquidity in the market.



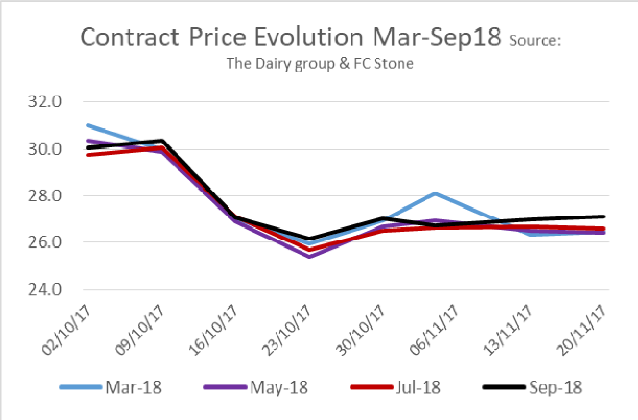
The Milk Futures Equivalent (UK MFE) settlement value each month as published by FC Stone shows a good correlation to AMPE as published by AHDB each month. As the graph shows this means that the futures market ends up in line with the physical market when the contract months come to an end as would be expected. UKMFE is a strong futures AMPE proxy and can be treated like AMPE.

In the 2014 review of AMPE by AHDB, which charted the historical link back to IMPE and the changes made through the Milk Marque period and recommendations to update for the current decade, AMPE is clearly a creamery based value that includes a profit margin, transport to store and interest on delayed payment. It is an equivalence to a contract standard litre in that farmers pay for transport to the dairy and it is adjusted by milk quality, hygiene, seasonality and bonuses. In a futures contract these adjustments should not be made due to the cash settlement on the contract, but there will be costs associated with the futures contract such as basis risk, commission and margin finance. These deductions may amount to 2 ppl but certainly not 4 ppl which makes UK MFE unattractive for the majority of the milk price cycle.

As the graph opposite shows, futures markets don't predict the future, they respond to the current market conditions in the short term and trend towards the cycle average over the medium term. Even over as little as 4 months as illustrated in the graph, the futures price failed to predict any change in the wholesale prices. They react to the spot market and there is no implied forecast of market prices. Forward futures pricing tends towards an average which is swayed by spot market sentiment. As cream/butter prices fell in October the futures market crashed, but has now recovered to an above average position. This is despite supply data in the EU and New Zealand suggesting otherwise for 2018, which reflects the actual supply balance in cream and butter in the run up to Christmas 2017 affecting futures pricing through much of 2018.



Tying any operator into futures pricing for 12 months, with no escape irrespective of market conditions is certainly novel and grossly unfair. Decisions regarding participation had to be made at a point in the cycle only 2 months ago on information that no longer applies. The graph shows the price evolution of contract months during the summer of 2018. The prices fell based on the fall in cream/butter prices up to 11 months before which had been at record levels and unlikely to sustain for that length of time. The same would apply if the market had been low but suddenly took off, access would have been denied until some future date. The short term volatility of the futures market means that participants need to able to opt in or out subject to conditions to ensure normal market function. Futures markets depend on a high volume of participation to function correctly. The rapid decline in futures prices in October and their partial recovery are all indicators of a very low level of participation in the dairy markets on the EEX. Reaction and over reaction become common features where a market has too few players to mollify volatility in the spot markets. With SMP moribund on the back of high cream/butter prices that could have provided a cross sector subsidy enabling disposal of SMP at close to Intervention price levels. Now with intervention stores shut and cream/butter pricing coming back to global levels there is limited opportunity going forward exacerbated by a surge in EU milk production. All these factors were known before October and yet failed to affect the 2018 futures price until the cream/butter value fell. The likely pricing in 2018 hasn't actually changed in that supply was always going to respond to higher milk prices, the butter shortage was on a cumulative basis, not on a monthly supply basis through the autumn. Markets in early 2018 were always likely to be lower because there is often a post festive season slump in demand.



On the NZX where participation is greater the bid-offer spread in prices is only 2 to 3% compared to the EEX where it is 7 to 10% most months, but a massive 30% for November. This can only mean greater volatility with markets undecided how to price commodities right up the settlement day. Until the EEX matures in size and scale it is not a market that farmers should be engaged in unless they are able to manage the risk and put up a significant margin.

The farm gate prices are volatile enough without exposure to futures prices that show an exacerbated level of volatility due to the immaturity of the market. In the future, if the EEX continues to grow or can offer a more farmer appropriate interface there may be opportunities for farmer participation. The engagement will need to be very flexible, allow loss making positions to be closed out and most of all allow farmers to dip in or out as market conditions dictate. The futures markets will have a role, but not for everyone and not all the time.

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For further information please contact:

- **Nick Holt-Martyn,** The Dairy Group (01823 444488/e-mail: nick.holt-martyn@thedairygroup.co.uk)
- **Visit www.thedairygroup.co.uk**
- The MPE is calculated from the weighted actual wholesale prices for liquid milk, cheese, butter and powders after the normal processing costs. The MPE accounts for 90% of the United Kingdom market utilisation of milk. AMPE (Actual Milk Price Equivalent) also only accounts for 14% of United Kingdom milk production. The MPE provides a far superior indicator of the wholesale value of milk and therefore the likely market returns available to the dairy farmer.